

II. PROCEDURES

A. Review of the Investigative Reports

The initial engagement of Kroll and the Audit Committee (collectively, the “Audit Committee”) was to review the investigative work of Vinson & Elkins and the City Attorney.⁵¹ An initial review of Vinson & Elkins’s investigation showed that it had not fully documented its procedures or, in some instances, the basis for its conclusions. Initial requests to examine the work papers and documents that supported the City Attorney’s investigative procedures and published reports were rebuffed.⁵²

Beginning in May 2005, Vinson & Elkins worked to complete a second report utilizing additional investigative procedures recommended by KPMG. Although Vinson & Elkins never officially issued a second report, it did prepare a series of draft memoranda, dated July 15, 2005, that summarized its findings (the “2005 V&E Report”).⁵³ These summary memoranda were provided to the City Council in August 2005.

The City Attorney’s Office initially ignored repeated requests from the Audit Committee for information about its investigation beyond its reports and exhibits, which were available on the City’s website.⁵⁴ This delayed the Audit Committee’s comparison of the conclusions of the City Attorney’s reports against the Vinson & Elkins reports. It was not until August 2005, five months after the Audit Committee had been formed, that the City Attorney’s Office provided the Audit Committee with documents used to support its investigation.⁵⁵ However, these documents did not provide support for the investigative

⁵¹ Our analyses and observations are based solely on the financial information, explanations, and representations that have been provided to us in the course of our investigation. The Audit Committee has not been engaged to nor have we performed a financial audit, review, or compilation as those terms are defined in the pronouncements on professional standards issued by the American Institute of Certified Public Accountants, of the respective financial statements of the City as of any date or for any period, nor do we express any financial audit, review, or attest opinion with regard thereto. Additionally, we have not performed any “agreed upon procedures” as defined in such pronouncements. This report presents our analyses and observations, as of the date of our investigation. To the extent that any relevant documents or information come to our attention after the date of the report, we reserve the right to review any such information and to supplement and/or modify our conclusions; however we are under no obligation to do so.

⁵² Letter from Troy Dahlberg, Audit Committee Member, Audit Committee of the City of San Diego, to Michael J. Aguirre, City Attorney (May 20, 2005); Letter from Lynn E. Turner and Troy Dahlberg, Audit Committee Members, Audit Committee of the City of San Diego, to Michael J. Aguirre, City Attorney (July 27, 2005).

⁵³ Paul S. Maco & Richard C. Sauer, Vinson & Elkins LLP, Potential Violations of the Federal Securities Laws by the City of San Diego and Associated Individuals and Accompanying Memoranda (Draft July 15, 2005). These memoranda, which were never issued in final form, were provided to the City by the Audit Committee on August 1, 2005.

⁵⁴ <http://genesis.sannet.gov/infospc/templates/attorney/index.jsp>

⁵⁵ Letter from Michael J. Aguirre, City Attorney, City of San Diego to Troy Dahlberg, Audit Committee of the City of San Diego (Aug. 5, 2005). The City Attorney’s Office long-delayed cooperation with the Audit Committee came on the same day that the Audit Committee informed the Mayor and Council that “the City Attorney’s lack of

procedures used by the City Attorney's Office. City Attorney Aguirre has spent an inexplicable amount of time questioning the validity and independence of the Audit Committee.⁵⁶ The City Attorney has stated his Office is better suited to conduct an independent investigation than the Audit Committee, despite the fact that he both represents the City and is also the current head of an office whose role is central to the events being investigated. Notwithstanding the City Attorney's interference, the Audit Committee has nevertheless found aspects of his Reports to be meritorious and useful in its investigation. Ultimately, however, the Audit Committee concluded that the City Attorney's investigation, much like the original Vinson & Elkins investigation, was not sufficiently comprehensive or objective and did not fully document its conclusions.⁵⁷

The Audit Committee's review of the Vinson & Elkins and City Attorney reports and investigative procedures confirmed that additional procedures, as contemplated by the February 14, 2005 and March 8, 2005 resolutions, would be necessary to "reach conclusions or obtain evidential matter that is required" by the City's auditor.⁵⁸ Such additional procedures included the review of documents not reviewed by either investigation; an "audit" of documents previously reviewed; an analysis of interviews conducted in order to determine if new interviews were needed; an evaluation and analysis of pension accounting and related financial reporting; a review of specific disclosure and issue binders compiled by Vinson & Elkins; and a new investigation into the City's sewer rate structure.⁵⁹

B. Document Production

At the outset of the federal investigations, the City – and its counsel, Vinson & Elkins – failed to implement a comprehensive strategy to preserve all documents and respond to the various subpoenas.

cooperation with our investigation is significantly hampering our efforts." Letter from Troy A. Dahlberg to Mayor & Council Members via Toni Atkins, Member of the City Council, City of San Diego (Aug. 5, 2005); *see also* Memorandum from Troy Dahlberg and Benito Romano, Audit Committee of the City of San Diego, to Michael Aguirre (Aug. 16, 2005) (discussing arrangements to begin review of the documents used by the City Attorney's Office in its investigation).

⁵⁶ *See, e.g.*, Letter from Michael J. Aguirre, San Diego City Attorney, to Arthur Levitt, Troy Dahlberg, and Lynn Turner, Kroll Associates, Inc. (Aug. 11, 2005) (informing the Audit Committee that "the San Diego City Attorney considers neither Kroll nor you to be independent with respect to any review of illegal acts investigations involving the City of San Diego"); City Attorney Michael J. Aguirre, Interim Report No. 8 Report on Kroll's Breach of Legal Duties Owed to the City of San Diego (Apr. 13, 2006). The positions of the City Attorney seem inconsistent with the substance of the engagement letter and resolution, both signed by his Office, empowering the Audit Committee to use any investigative procedures necessary to conduct a thorough investigation.

⁵⁷ The lack of investigative documentation in the work product provided to the Audit Committee by the City Attorney has left the Audit Committee unable to assess the sufficiency of the investigative procedures used, a necessary step to evaluate the factual and legal conclusions of the Reports. For example, to date, it is not clear whether the City Attorney's Office conducted formal interviews in conjunction with its investigation, and if so, what processes it used.

⁵⁸ Letter from Troy Dahlberg, Managing Director, Kroll Associates, Inc., to Hon. Richard Murphy (Feb. 10, 2005).

⁵⁹ As a result of additional allegations made during the course of its investigation, the Audit Committee was asked to look into a number of additional issues, which are discussed in Appendix Q to this report.

At the onset of investigations, there was no City-wide to attempt to notify all employees that the City had received document requests and subpoenas from the SEC and U.S. Attorney's Office and instruct them to preserve all documents and not delete records from computer hard drives or e-mail mailboxes.⁶⁰ Nor were copies of the document requests and subpoenas disseminated, or instructions provided to all employees regarding the scope of production called for by these requests. In the early summer of 2005, at the request of the SEC and U.S. Attorney's Office, the Audit Committee began to work with the City to achieve full compliance with all outstanding document requests and subpoenas. Interviews conducted by Vinson & Elkins after it issued its report in 2004 revealed that files potentially responsive to the Government's requests had been destroyed and that many City employees and officials had not even seen the subpoenas.⁶¹

At the request of the Audit Committee, Mayor Murphy and City Manager Ewell sent a memorandum on June 10, 2005, to more than 11,000 City employees, the City Council and SDCERS advising each employee and official to review a series of document requests and subpoenas and determine if they had any potentially responsive documents (the "June 10th Memo").⁶² The June 10th Memo also provided detailed instructions for each recipient to search his or her electronic and non-electronic files, identify all potentially responsive documents, and fill out a certification attesting to the fact he or she either possessed or did not possess responsive documents.⁶³ If an individual certified to having responsive documents, he or she was then contacted by the Audit Committee and asked to produce any responsive

⁶⁰ Although City Attorney Casey Gwinn sent an e-mail to senior City supervisors alerting them to the federal inquiries and instructing them not to destroy or discard any records in their possession, there is no indication that anyone besides the Auditor and Comptroller's Office forwarded it on to subordinates who might also possess documents. E-mail from Casey Gwinn to Casey Gwinn (Feb. 14, 2004); E-mail from Terri Webster to Darlene Morrow-Truver, Ed Wochaski, Holly Reed-Falk, Jeanne Cole, Marian Thompson, Maria Weston, Nicole LeClair-Miller, Phillip Phillips, Rudy Graciano, Bob Wilson, Tracy McCraner (Feb. 15, 2004). And although the City Attorney's Office "froze" the e-mail system so that the system would not automatically delete e-mail, it did not "freeze" the server system (H Drives) where all City employees, including the Auditor & Comptroller's Office, stored most of their files. The servers were not specifically backed up for the investigation and the standard location for all archived e-mails was their H Drive. E-mail from Casey Gwinn (Feb. 20, 2004).

⁶¹ Memorandum from Paul S. Maco to P. Lamont Ewell, City Manager, City of San Diego (Jan. 31, 2005) (regarding an incident in which a member of the Financing Services division of the City Treasurer's Office stated that files from the "entire staff" had been purged during a "file cleaning day" after authorization by a Deputy City Attorney). Paul S. Maco and Richard C. Sauer, Vinson & Elkins LLP, *Untitled Document Discussing Document Production Accompanying Potential Violations of the Federal Securities Laws by the City of San Diego and Associated Individuals* at 7, 18-19, 22-25 (Draft July 15, 2005). According to Vinson & Elkins, "the City Attorney's Office determined not to circulate the underlying SEC and U.S. Attorney subpoenas to all employees, based on concerns about the confidentiality instructions contained in the subpoenas." *Id.* at 7.

⁶² E-mail from P. Lamont Ewell to All City Employees with attached Memorandum from Mayor and City Manager to All City Employees, City Council, and San Diego City Retirement System (June 10, 2005).

⁶³ E-mail from P. Lamont Ewell to All City Employees with attached Memorandum from Mayor and City Manager to All City Employees, City Council, and San Diego City Retirement System (June 10, 2005).

documents that had not been provided previously to the City's document repository.⁶⁴ The Audit Committee did not itself determine if documents were responsive to the various document requests; rather, each individual employee was responsible for determining responsiveness.⁶⁵ The June 10th Memo represented the first comprehensive effort to identify and collect documents requested through the subpoenas and document requests issued by the SEC and U.S. Attorney's Office. Documents were produced to the City's repository starting in August 2005. After they were produced to the repository, the SEC and U.S. Attorney's Office received or were provided access to these documents by the City Attorney's Office.

C. Document Review

At the outset of its investigation, the Audit Committee had not planned to conduct a comprehensive document review. However, it quickly became apparent that a simple audit of the previous document reviews would not suffice: Vinson & Elkins's review of data was incomplete and needed to be redone; the City Attorney apparently had not applied any formal, documented methods in conducting its review; SDCERS withheld a large number of documents on grounds of attorney-client privilege; and a large universe of new, previously un-reviewed documents had been produced in response to the June 10th Memo.

The Audit Committee also discovered that previous investigations failed to review e-mail boxes, hard drives and network drives for members of the City Council and their staff.⁶⁶ In addition, the Audit Committee determined that over 50,000 files (e-mails and/or attachments) had not been reviewed by Vinson & Elkins.⁶⁷ Additionally, it became apparent the City Attorney's Office reviewed only a targeted set of documents produced by key individuals in response to the assorted federal document requests and subpoenas.⁶⁸ The City Attorney's Office failed to follow adequate investigative procedures by reviewing only this narrow population of documents without, for example, applying key word searches to the larger universe of all potentially relevant documents.

Additionally, the prior investigations had failed to obtain images of all hard drives of individuals identified by the Audit Committee as relevant to its investigation. The Audit Committee

⁶⁴ E-mail from P. Lamont Ewell to All City Employees with attached Memorandum from Mayor and City Manager to All City Employees, City Council, and San Diego City Retirement System (June 10, 2005). The document repository to which documents were produced was managed by the City Attorney's Office.

⁶⁵ The Audit Committee and its legal counsel advised each employee it contacted that it was independent and did not represent the employee or the City.

⁶⁶ The Audit Committee discovered that some City Council members, as well as former Mayor Richard Murphy, utilized two GroupWise e-mail boxes: one to send and receive constituent mail, and one used with staff and City officials. Not all of these e-mail boxes had been produced.

⁶⁷ These files had failed to upload to the electronic review database, and, therefore, had not been reviewed by Vinson & Elkins.

⁶⁸ City Attorney Aguirre conveyed this information to Audit Committee member Troy Dahlberg.

requested hard drive information in October 2005 and again in December 2005. Some, but not all, of the requested information was ultimately provided to the Audit Committee. However, the imaging of key hard drives was delayed for weeks by a lack of cooperation by the City Attorney's Office, which appears to have instructed its technical staff not to provide this information to the Audit Committee.⁶⁹

The Audit Committee's attempt to review all relevant documents was further impeded by the fact that SDCERS had withheld a large number of documents from production on grounds of attorney-client privilege.⁷⁰ SDCERS eventually agreed to waive this privilege and some of these documents were produced in late September 2005.⁷¹ However, requests for access to SDCERS e-mail boxes and additional documents resulted in long and arduous negotiations, and SDCERS did not produce these documents to the Audit Committee until May 2006.⁷²

At the Audit Committee's request, the City provided a list of consultants that performed work for the City in areas related to the investigation. The Audit Committee requested e-mail and hard copy documents from those consultants in early Fall 2005. Although several consultants refused to provide documents, the majority did produce them on a rolling basis.⁷³

Electronic document review took place October 2005 and February through June 2006.⁷⁴ The Audit Committee reviewed more than one million documents and records during the course of its investigation.

⁶⁹ E-mail from David Bond to Jennifer Arnini and Jeffrey Klein cc to Rey Arellano (Jan. 24, 2006) (the Information Systems Analyst who supports the City Attorney Office's hard drives informed the Audit Committee that much of the information it sought should be "requested directly by the Audit Committee of the City Attorney"). Due to this lack of cooperation by the City Attorney's Office, the imaging of key hard drives from the City Attorney's Office was delayed at least 3 weeks.

⁷⁰ A review of the privilege log provided by SDCERS counsel, Seltzer Caplan McMahon Vitek, revealed that many of the documents for which a privilege was claimed were not actually privileged.

⁷¹ Letters from Annette Vitelli, Paralegal, Seltzer Caplan McMahon Vitek, to David Callaghan (Sept. 2, 2005, Sept. 8, 2005, and Sept. 14, 2005).

⁷² After a failure to resolve issues surrounding the production of these documents, the Audit Committee contacted the SDCERS President directly to discuss the matter in March 2006. Letter from Troy A. Dahlberg, Audit Committee member, Audit Committee of the City of San Diego, to Peter Prevolos, President – San Diego City Employees' Retirement System (Mar. 23, 2006). An agreement to review these documents was not reached until April 4, 2006. Agreement Granting Access to Documents (Apr. 4, 2006). The documents requested were eventually made available to the Audit Committee in May 2006.

⁷³ In total, the Audit Committee reviewed more than 45 boxes of documents and four disks of electronic data collected from consultants. A list of consultants who received document requests from the Audit Committee is attached to this report at Appendix E.

⁷⁴ Document review ceased for several weeks between November 2005 and February 2006 due to technical problems with the data previously collected by Vinson & Elkins (resulting from both the extraction of data from the City's GroupWise e-mail system and the uploading of that data onto the database used to conduct the review). An outside consultant, Novell, Inc., was engaged by the City to fix these technical issues and redo (and expand) the extraction of e-mails of the GroupWise system.

D. Interviews

The Audit Committee interviewed 68 current and former City employees, officials, and consultants from September 2005 through June 2006. More than 146 individuals received letters and phone calls from the Audit Committee requesting interviews.⁷⁵

KPMG had expressed to the Audit Committee methodological concerns over the interview procedures employed by Vinson & Elkins in its investigation, including providing copies of documents used as interview exhibits to the witness in advance of the interview and permitting witnesses to review and edit a copy of the interview summary prepared by the interviewing attorney team. The City Attorney Interim Reports do not reflect that the City Attorney's Office conducted formal interviews as part of its investigation. As a result, interviews conducted by the Audit Committee were a key component of the "additional procedures" necessary to its investigation.

E. Additional Analysis

With the authorization of the City Council, the Audit Committee engaged PricewaterhouseCoopers to perform actuarial analyses related to its investigation. Additionally, the Audit Committee has conducted a factual review of a report, commissioned by SDCERS, entitled "Investigation for the Board of Administration of the San Diego City Employees' Retirement System," the end result of an internal investigation by Navigant Consulting, Inc. (the "Navigant Report").⁷⁶ The Navigant Report is accompanied by a legal analysis and legal conclusions prepared by the law firm of Reish, Luftman, Reicher & Cohen (the "Reish Luftman Report").⁷⁷

F. Legal Analysis

In addition to the factual review and comparison of other investigative reports pertaining to the pension system, the Audit Committee, through its legal counsel, has conducted a legal analysis of those reports, identified and researched additional legal issues, and reached independent conclusions on all legal issues. These reports included the 2004 and 2005 Vinson & Elkins Reports, the City Attorney Reports, the Luce Forward Report,⁷⁸ the Navigant Report, and the Reish Luftman Report.⁷⁹

⁷⁵ A complete list of individuals who were interviewed or declined to be interviewed is attached to this Report as Appendix D.

⁷⁶ Navigant Consulting, Inc., Investigation for the Board of Administration of the San Diego City Employees' Retirement System (Jan. 20, 2006).

⁷⁷ Reish Luftman Reicher & Cohen, Legal Analysis of Investigative Report on the San Diego City Employees' Retirement System (Jan. 20, 2006).

⁷⁸ The law firm of Luce, Forward, Hamilton & Scripps LLP ("Luce Forward") provided the City of San Diego with a legal analysis of "specific matters analyzed in discovery" during *Gleason v. San Diego City Employees' Ret. Sys.* and the Vinson & Elkins investigation. Luce, Forward, Hamilton & Scripps LLP, Legal Research Concerning Certain Pension-Related Issues for the City of San Diego (Feb. 22, 2005). At the request of the City, Luce Forward also

Additionally, the Audit Committee monitored a number of litigations in state and federal courts that involve persons, facts and legal allegations related, directly or indirectly, to its investigation.⁸⁰

Throughout the course of its investigation, the Audit Committee provided regular updates to the City Council, including appearances before the Council on February 12, 2005, March 8, 2005, May 10, 2005, August 9, 2005, September 26, 2005, October 24, 2005, November 1, 2005, January 17, 2006 and

provided a supplemental legal analysis regarding one of the issues (the payment of supplemental retirement benefits with surplus earnings) in their report. Supplemental Memorandum from Luce, Forward, Hamilton & Scripps LLP to P. Lamont Ewell, City Manager, City of San Diego, and Lynn E. Turner (May 12, 2005). Collectively, these legal analyses are the “Luce Forward Report.”

⁷⁹

Paul S. Maco & Richard C. Sauer, Vinson & Elkins LLP, Report on Investigation, The City of San Diego, California’s Disclosures of Obligation to Fund the San Diego City Employees’ Retirement System and Related Disclosure Practices 1996–2004 with Recommended Procedures and Changes to the Municipal Code (Sept. 16, 2004); Paul S. Maco & Richard C. Sauer, Vinson & Elkins LLP, Potential Violations of the Federal Securities Laws by the City of San Diego and Associated Individuals (Draft July 15, 2005); City Attorney Michael J. Aguirre, Interim Report No. 1 Regarding Possible Abuse, Fraud, and Illegal Acts by San Diego City Officials and Employees (Jan. 14, 2005); City Attorney Michael J. Aguirre, Interim Report No. 2 Regarding Possible Abuse, Illegal Acts or Fraud by City of San Diego Officials (Feb. 9, 2005); City Attorney Michael J. Aguirre, Interim Report No. 3 Regarding Violations of State and Local Laws as Related to the SDCERS Pension Fund (Apr. 9, 2005); City Attorney Michael J. Aguirre, Interim Report No. 4 Regarding Additional Funding for Outside Professionals Reviewing Alleged Illegal Acts (May 9, 2005); City Attorney Michael J. Aguirre, Interim Report No. 5 Regarding the Legal Status of the Elected Officers Retirement Program (May 18, 2005); City Attorney Michael J. Aguirre, Amended Interim Report No. 6 Regarding the San Diego City Employees’ Retirement System Funding Scheme (July 1, 2005); City Attorney Michael J. Aguirre, Wastewater Interim Report No. 1 City of San Diego Officials’ Failure to Disclose Material Facts in Connection with the Offer and Sale of Wastewater Bonds and Related Improper Activity (Sept. 15, 2005); City Attorney Michael J. Aguirre, Interim Report No. 7 SDCERS Attorney-Client Privilege Documents Released Under Federal Court Order (Dec. 6, 2005); City Attorney Michael J. Aguirre, Interim Report No. 8 Report on Kroll’s Breach of Legal Duties Owed to the City of San Diego (Apr. 13, 2006); Navigant Consulting, Inc., Investigation for the Board of Administration of the San Diego City Employees’ Retirement System (Jan. 20, 2006); Reish Luftman Reicher & Cohen, Legal Analysis of Investigative Report on the San Diego City Employees’ Retirement System (Jan. 20, 2006).

A legal analysis was not performed on a City Attorney Report discussing allegations against Vinson & Elkins, which was issued shortly before this report went to print. City Attorney Michael J. Aguirre, Interim Report No. 9 Report on Breach of Contract, Fiduciary Duties, and Professional Negligence by Vinson & Elkins LLP (July 26, 2006). A tenth City Attorney Report, discussing certain improper billing practices at the City Attorney’s Office, was reviewed by the Audit Committee but did not contain any legal analysis. City Attorney Michael J. Aguirre, Interim Report No. 10 Report to Auditor Related to Improper Billing Practices for Service Level Agreements with City of San Diego Water and Wastewater Departments (July 28, 2006).

⁸⁰

These litigations include *City of San Diego v. Callan Associates, Inc.*, No. GIC 852419 (Cal. Super. Ct. Aug. 15, 2005); *City of San Diego v. Murphy*, No. GIC 854373 (Cal. Super. Ct. Sept. 23, 2005); *City of San Diego v. Orrick Herrington & Sutcliffe*, No. GIC 857632 (Cal. Super. Ct. Nov. 30, 2005); *Newsome v. San Diego City Employees’ Ret. Sys.*, No. GIC 8568421 (Cal. Super. Ct. Nov. 14, 2005); *San Diego City Employees’ Ret. Sys. v. Aguirre*, No. GIC 841845 (Cal. Super. Ct. July 26, 2005); *San Diego City Employees’ Ret. Sys. v. City of San Diego*, No. GIC 851286 (Cal. Super. Ct. Feb. 9, 2005); *San Diego City Employees’ Ret. Sys. v. City of San Diego*, No. GIC 861125 (Cal. Super. Ct. 2006); *Zucchet v. City of San Diego*, No. GIC 857389 (Cal. Super. Ct. Nov. 23, 2005); and *San Diego Police Officers’ Association v. Aguirre*, No. 05 CV 1581H (S.D. Cal. 2005); *Gleason v. Gabriel, Roeder, Smith & Co.*, No. GIC 849882 (Cal. Super. Ct. June 28, 2005); *Wood v. Hanson, Bridgett, Marcus, Vlahos & Rudy, LLP, et al.*, No. GIC 830558 (Cal. Super. Ct. May 26, 2004). The Audit Committee has also monitored two actions, previously mentioned, that have been brought by the State of California through the San Diego District Attorney: *People v. Lexin*, No. CD 190930 (Cal. Super. Ct. May 17, 2005), and *People v. Grissom*, No. GIC 850246 (Cal. Super. Ct. July 6, 2005).

May 8, 2006. The Audit Committee provided the City Council with written updates on May 6, 2005, June 10, 2005, June 27, 2005, August 5, 2005, September 7, 2005, September 23, 2005, October 7, 2005, October 19, 2005, October 25, 2005, and January 13, 2006. In addition to these updates, the Audit Committee has informally apprised the Council and, upon his election, Mayor Jerry Sanders and his staff, of the progress of the investigation in meetings and telephone calls.